IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

L. V. WELLS, *Appellant,* *vs.* J. B. LINCOLN, as Trustee in Bankruptcy of the Estate of the Wenatchee Heights Orchard Company, a corporation, Bankrupt, *Appellee.*	No. 2358

In the Matter of the Wenatchee Heights Orchard Company, a Corporation, Bankrupt.

BRIEF ON BEHALF OF J. B. LINCOLN, TRUSTEE, ETC., APPELLEE.

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STATEMENT OF FACTS.

A full and complete statement of the facts, from our standpoint, is set out in the brief filed on behalf of the Trustee in his appeal and, therefore, we shall not attempt to give a complete statement of facts in this brief, but shall content ourselves with a reference to a few of the statements made in the brief on behalf of appellant Wells which we feel are not justified or supported by the record.

On pages 7 and and 8 of that brief a statement is made that Gates offered to take the two notes for

the conveyance of practically all the assets of the bankrupt company to the Summit Investment Company. This statement is probably inadvertent. There is no dispute, nor ever has been, as to what Gates actually offered. His communication is set forth in full at page 37 of the record, and was a statement that he owned the two notes and in payment of them would take a conveyance of the property there described.

There is no evidence to justify the statement that there was no intention of ever cancelling the notes of Wells and McPherson which were paid by the transfer to Gates. Both Wells and McPherson, in one part of their testimony, state that the notes were actually transferred to Gates, and in another part, that they were not transferred but were always in their possession. Neither is there any evidence whatsoever in the record, nor was there any at the hearing, to support the statement made in the brief that the suit brought in the Superior Court was started without any demand being made upon Wells or McPherson or the Company for a reconveyance of the property to the Wenatchee Heights Orchard Company. So far as the record appears, there is nothing whatever to explain whether the suit was brought without demand or whether it was brought

because of a failure to respond to a demand for a reconveyance of the property.

By our silence as to the statements made in the Wells brief as to the effect of the agreement made as a result of the suit in the Superior Court, we do not wish to be understood as acquiescing therein. Our views as to the effect of this agreement upon the alleged claim of L. V. Wells will be set forth quite fully in the latter portion of this brief.

ARGUMENT.

I.

The basis of the brief submitted by Wells and the premise upon which all the argument therein must rest is that, the conveyance by the Wenatchee Heights Orchard Company to the Summit Investment Company was merely a preference to Wells and McPherson, and that, therefore, no punishment should be inflicted on them other than the loss of their preference. In support of this contention numerous cases have been cited. We have no dispute whatever with the law announced in *Hutchinson vs. Otis, Wilcox & Co.*, 190 U. S. 552; *Keppel vs. Tiffin Savings Bank*, 197 U. S. 356, or *Page vs. Rogers*, 211 U. S. 575. In our view of this case,

however, none of these cases has the slightest application to the facts as found in the record here.

There is all through the Bankruptcy Act a distinction between transfers of property which are fraudulent as against creditors and transfers of property which are mere preferences. This distinction is not only one of words. It is a real, substantial distinction which is drawn as a result of the facts surrounding the transaction and the intention of the parties, and which results in a great difference of punishment to be inflicted upon the guilty party. A preference is defined in Sec. 60-A of the Bankruptcy Act as follows:

> "A person shall be deemed to have given a preference if, being insolvent, he has *within four months before the filing of the petition, or after the filing of the petition and before the adjudication* * * * made a transfer of any of his property and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other creditor of the same class."

The original Act, in defining a preference, omitted the words italicized in the above quotation, making any transfer of property the effect of which was to enable a creditor to obtain a greater percentage of his debt than other creditors of the same

class, a preference irrespective of the time when it was made. Under the Act as amended, however, there is no preference unless the transfer was made within four months of the filing of the petition. In the case at bar the transfer in question was made October 10th, 1911, more than one year prior to the filing of the petition. Manifestly, it could not be a preference, time being one of the essential elements under the Act as amended.

Not only is the length of time fatal to the consideration of this claim as a preference, but there are other reasons why it should be considered not as a preference but solely as a transfer, with the intent to hinder, delay and defraud creditors.

One other essential, in fact the most important one, to the commission of an act of bankruptcy is, that there should be a transfer of property, the effect of which will be to enable a creditor to obtain a greater percentage of his debt than any other creditor of the same class. Now it is contended by Wells in this case, not only prior to the institution of these proceedings but now in this court, that his debt was not paid nor secured, nor was McPherson's, by the transfer of the property to the Summit Investment Company. He says in his brief, in the statement to which we have alluded, on page 8, that

"The two notes of Wells and McPherson were never out of the possession of the payee; there *was no intention of cancelling them and they were, in fact, not cancelled.*" Now, if this statement is true, the property transferred to the Summit Investment Company was not given in payment of the notes issued to Wells and McPherson. There is no contention made now that the conveyance was intended to be a mortgage, or security for the notes. There never has been any such claim. Consequently, there was not a conveyance to a creditor nor to any one for his benefit, the effect of which was to enable the creditor to realize a greater portion of his claim than the other creditors of the same class. The notes to Wells and McPherson, according to this claim, were still outstanding, valid claims against the company and were unsecured and so remained at all times. How then can it be said that by this transfer Wells and McPherson, or any creditor, was able to receive a greater percentage of his debt than other creditors of the same class? It is true that if Gates, although he was not legally bound to do so, would hold the stock of the Summit Investment Company in trust for Wells and McPherson, they would receive more property than they otherwise would have received, but this property, according

to their present contention would not have been received as a payment of their debt but as their share of the plunder from the looting of the Wenatchee Heights Orchard Company and would not affect the percentage they would receive on their claims, except to reduce it, because on the final wind-up there would be that much less to divide among the creditors including themselves. Consequently, every material element of a preference is lacking in the present conveyance. It is without the time limit and it did not have the effect of giving a creditor a greater percentage of his debt. According to this theory, it is merely a conveyance with a secret trust in favor of the grantor.

II.

Looking at the transfer, however, from the standpoint of what the record of the Wenatchee Heights Orchard Company—made at the time—shows, and as it appears, according to the testimony of Wells, given in the bankruptcy proceeding, we still contend that this conveyance must be looked at, not as a preference, but as a conveyance to hinder, delay and defraud creditors.

Prior to the enactment of the bankruptcy law in 1898, there was no reason known to a court of

equity why an insolvent debtor should not transfer to a *bona fide* creditor, with the intention of paying him, any portion of his property, so long as the property was conveyed at a fair valuation and solely with the honest intention of paying the creditor. The mere fact that the creditor would receive more than others was not considered wrong in a court of equity. There were known, however, to courts of equity ever since they have been established, conveyances made for the purpose of hindering, delaying and defrauding creditors. Those have always been subject to attack and condemnation wherever found. The distinction between the two has been recognized by the Bankruptcy Act. In its definition of a preference and the denunciation thereof and its provision for the return of the property conveyed as a preference, the Bankruptcy Act limits the punishment to a return of the property. In other words, it says that in such an act there is nothing immoral nor illegal nor contrary to the principles of honesty and fair dealing insisted on by a court of equity. This is merely an act which for the purpose of procuring an equal distribution of an insolvent, debtor's property, if it is followed within four months by the bankruptcy of the grantor, has been declared by Congress to be subject to rescission. As to conveyances made with intent to

hinder, delay and defraud creditors, however, the Bankruptcy Act takes a different view. It allows the laws of the State Court to govern, and provides simply that any conveyance which, as against the creditors of the bankrupt is void, shall be void as against the trustee. In other words, it makes the trustee the representative of the creditors to set aside any conveyances which they themselves could have set aside had bankruptcy not intervened. The remedies which a trustee has are the same as creditors had prior to the passage of the Act.

In this case there are two fundamental features which the trustee relies upon to show this transfer was actually made with the intent to hinder, delay and defraud creditors. First, the conveyance itself and the minutes which provide for it. In them is a letter from Gates in which he recites his ownership of the notes and his willingness to satisfy the notes upon a transfer of the property. That statement is presented to a meeting of the trustees at which are present—as the only trustees of the corporation—the payees of the two notes which Gates alleges have been transferred to him. That meeting (which is Wells and McPherson) adopts a resolution accepting the proposition. The minutes of this meeting will be found on page 84 of the record.

Mr. Wells in his testimony gives the reason and necessity for the performance. He says, at pages 90 to 92, practically, that they, (Wells and McPherson), believed others besides Hotchkin would be able to recover judgments against the company. Hotchkin, it will be remembered, had secured a judgment against the bankrupt for failing to supply sufficient water. Wells was anxious to discourage any further suits, and he believed that if he put the property of the company out of its name these persons, (the other creditors in this bankruptcy proceeding), would believe that the company had no property and that if they brought suit to recover they would not be able to realize thereon, and, therefore, for the purpose of discouraging them from commencing suit this transfer was made. It seems to us that comment on this testimony or argument to prove that it showed a wilful, deliberate attempt to defraud creditors is absolutely unnecessary.

Judge Cushman, in his opinion in this case, found that this conveyance was for the purpose of defrauding creditors and that it had that effect. Not only Judge Cushman found it on the hearing on this claim, but the referee found it also, and both the referee and Judge Cushman found the same

thing in the hearing on the adjudication. The statement of counsel that the referee who heard witnesses on the stand had found them not guilty of fraud is not only without foundation in the record, but is absolutely untrue. In his first report as Special Master on the hearing on the adjudication the referee found this conveyance was made for the purpose of hindering, delaying and defrauding creditors. That holding was approved by the Court in the opinion by Judge Cushman found in 204 Fed. 674. The exceptions to the referee's report were overruled in the order of adjudication and consequently it has been conclusively adjudged in this case that this conveyance was a conveyance for the purpose of hindering, delaying and defrauding creditors prior to the filing of the claim of Wells. In the hearing on the claim, the Referee did not find Wells not guilty of fraud. He did find that there was no evidence of fraud in the original subscription to the capital stock, but under the later decisions of the Supreme Court, as shown in our brief, that question becomes immaterial. The only holding he made in the hearing on the claim as to the character of the conveyance to Gates is found quoted by Judge Cushman in his opinion and is as follows:

> "While it is possible that neither party to these transactions between the corporation and

> the Summit Investment Company would have been entitled to relief as against the other, yet having been obtained, the consideration, though fraudulent, must be returned."

It will thus be seen that every court that has passed upon this transaction has, at every step of the litigation, held that it was a transfer made with the intention of deliberately and wilfully defrauding the creditors of the Wenatchee Heights Orchard Company.

> *In re Wenatchee Heights Orchard Co.*, 209 Fed. 84.

Judge Dodge, sitting in the District Court of Massachusetts, *In re Maher,* 144 Fed. 503, which has been quoted with approval by the Supreme Court of the United States in *Coder vs. Arts,* 213 U. S. 223, makes very clear the distinction between a preference and a transfer in fraud of creditors, and makes clear the fact that there was no intention on the part of Congress to confuse the two, but that all through the Act there runs a clear distinction between the two classes of conveyances. In that case one of the grounds of objection to a discharge was that the bankrupt, with the intention to do so, had given a preference to one of his creditors, and the claim was made that that constituted an objection to his discharge under Sec. 14-b 4 which makes

it an objection to a discharge that a bankrupt has within four months transferred, removed, destroyed or concealed, or permitted to be removed, destroyed or concealed, any of his property with intention to hinder, delay or defraud his creditors. There was no question in the Maher case but what there had been a preference which was voidable, and, as shown in the opinion of Judge Dodge, the facts showed that the transfer was not such a one as would have been denounced by a court of equity prior to the passage of the Bankruptcy Act as a transfer to hinder, delay or defraud creditors. With the opinion of Judge Dodge is printed the report of the referee. Together they contain an admirable and complete history of the acts of bankruptcy with reference to this proposition. At page 505 of the opinion it is said:

> "In a preferential transfer the fraud is constructive or technical, consisting in the infraction of that rule of equal distribution among all creditors which it is the policy of the law to enforce when all cannot be fully paid. In a fraudulent transfer the fraud is actual—the bankrupt has secured an advantage for himself out of what in law should belong to his creditors and not to him."

This quotation, which is the one cited with approval by the Supreme Court in the case of *Coder vs. Arts, supra,* gives succinctly the real dis-

tinction between mere preference and transfers to hinder, delay and defraud creditors. The first is merely a violation of the bankruptcy provisions and embraces within it no idea of moral wrong-doing. The second necessarily includes an element of wilful fraud, such as is found in the testimony of Wells, referred to above.

As we have pointed out, this was found in the court below in his decision on this claim.

To the same effect see

Coder vs. Arts, 213 U. S. 223.

1 Loveland on Bankruptcy, 975.

Van Iderstine vs. Nat. Discount Co., 174 Fed. 518.

Githins vs. Shiffer, 112 Fed. 505.

Everything that has been done by Wells and McPherson prior to the filing of this petition has been done with the intent and purpose to make the records of the bankrupt show that the conveyance to the Summit Investment Company was an absolute one, which divested the Wenatchee Heights Orchard Company of any interest in the property conveyed, and that the consideration for the conveyance was the final and absolute payment of the notes mentioned in the proposal of Gates. Not until the adjudication and the passing out of their hands of

the control of the Wenatchee Heights Orchard Company did they ever contend otherwise. Even when the question of the liability of the Wenatchee Heights Orchard Company was a most material one, in the hearing on the adjudication, they never urged that these claims of theirs existed.

III.

One other question to be considered in an answer to the Wells brief is as to the effect of what counsel calls the voluntary restitution by the Summit Investment Company. We have pointed out in our brief, filed in the appeal of the trustee, that Wells must be estopped to claim that Gates did not have the notes and that the notes were not paid, he having induced the corporation to part with its property on the representation that they were in the hands of Gates and that this conveyance would pay them. So we may start this argument upon the premise that up to the time, at least, that the agreement was made between Benninghausen, Ryer, McElwain, Gates, the Summit Investment Company and the Wenatchee Heights Orchard Company, six days after the suit was filed in the State Court and a Receiver was appointed, the notes to Wells and McPherson were paid, and that the corporation

could have defended against any suit by Wells and McPherson.

It is claimed by counsel, without any foundation in the record, that the suit in the Superior Court was made without any demand and that this argument was voluntarily made by Wells and Gates. There is nothing in the record on the subject one way or another, but so long as counsel has travelled outside to insist that there was no demand and the agreement was voluntary, we think we may give what we understand to be the truth of the matter. That for the entire six days after the suit was started Mr. Gates stubbornly insisted that he and he alone was the actual owner of the stock of the Summit Investment Company, and that no one had anyq interest therein but himself, and that he did own the Wells note when he made the proposition and refused to give up any part of the property transferred to him. And it was only when legal proceedings other than civil were threatened, as a result of some of the transactions he had had with the bankrupt, that the agreement was finally entered into; and there is this in the record to substantiate that: That when the bankruptcy proceedings were commenced and Mr. Gates was on the stand, he insisted then that he owned the notes and that they

were transferred to him for a valuable consideration. At that time Wills, McPherson and Gates were defending against an adjudication and claimed the corporation was solvent and therefore they at that time desired to make the liabilities appear small. Consequently, it was not then claimed by them, or by the corporation which consisted of them and them alone, that these notes were outstanding. They were content with the testimony of Gates that the notes were his property and had been paid, because he then said the bankrupt owed him nothing whatever. This claim now that the notes were not paid and were not the property of Gates is playing fast and loose with the Court.

The agreement to which counsel refers, which was made with the hope of settling the State Court litigation, and the material parts of which are found beginning on page 93 of the record, did not transfer this property back to the Wenatchee Heights Orchard Company. The agreement provided that the board of trustees of the Summit Investment Company should be increased to five. It provided that Benninghausen, McElwain and Ryer, together with Wells and McPherson, were to be trustees; that Benninghausen was to hold all the stock "until", (and we quote from the agreement itself, on page

94), "the obligations of the said Wenatchee Heights Orchard Company shall have been performed, or until such prior time as the parties hereto shall agree that said stock shall be delivered by said trustee" (Benninghausen) "to such person or persons as the parties hereto shall appoint." Again, on page 96, still quoting from the agreement, "That the capital stock held by each of the parties hereto and by said G. Benninghausen, or his successor, shall be held," etc., * * * "until the obligations of the said Wenatchee Heights Orchard Company shall have been performed, or until the parties hereto shall have agreed otherwise." In other words, when the agreement was executed the property was not re-transferred to the Wenatchee Heights Orchard Company, nor did the agreement have the legal effect of transferring the property to the Wenatchee Heights Orchard Company. If the obligations of the Wenatchee Heights Orchard Company had amounted to fifty thousand dollars, and the total value of the property conveyed had been worth, as Wells and McPherson say they believe it was, one hundred thousand dollars, to whom would the fifty thousand dollar surplus have gone? Manifestly, under this agreement, the moment the obligations of the Wenatchee Heights Orchard Company

had been performed Benninghausen and the rest would have been obligated to transfer their stock in the Summit Investment Company back to the man from whom they received it—back to B. E. Gates—and he could have done with that property what he chose, because, it being a transfer to hinder, delay and defraud creditors, neither the Wenatchee Heights Orchard Company nor any of its stockholders could claim any relief if Gates refused to carry out his trusteeship (now claimed by Wells to have existed) and claimed the property absolutely. On that proposition no citation of authorities is necessary. Not only that, but at any time that Benninghausen, McElwain and Ryer had decided that they were satisfied, they could have agreed with Wells and McPherson and Gates to turn the shares of stock in the Summit Investment Company, and with them the control of the property, back to Gates, the fraudulent grantee, and the remaining creditors of the Wenatchee Heights Orchard Company would have been left as they were before the State Court suit had been commenced, to commence anew an action to set aside the conveyance.

Again, what virtue can Wells claim by reason of the fact that Benninghausen, McElwain and Ryer, a majority of the board of trustees of the

Summit Investment Company, themselves creditors of the corporation, in violation, if you will, of their agreement with Wells, turned this property over to the trustee in bankduptcy of the Wenatchee Heights Orchard Company? It was not through any act of Wells that they turned it back. He took no part in it. He could not have prevented it. It was transferred because, as the resolution recites, the District Court of the United States, in the original hearing on the adjudication in this case, had, as a necessary part of its decision, held the transfer to the Summit Investment Company fraudulent and void as against the creditors. If that act of the majority of the trustees of the Summit Investment Company gave rise to any right on the part of Wells, it was a right of action against the Summit Investment Company, or against Benninghausen, Ryer and McElwain, the trustees, individually, for a violation of the agreement entered into in the Superior Court suit. But to that suit there would have been the absolute defense that the conveyance to the Summit Investment Company was in fraud of creditors; that Wells could not set up his own fraud and ask any relief on it, and that the Summit Investment Company was entitled to hold that property free from any claim of the Wenatchee

Heights Orchard Company or its stockholders. Now, if he had no right of action against the Summit Investment Company, which had agreed to hold the property for him, why a right of action against the Wenatchee Heights Orchard Company because its fraudulent grantee failed to keep the agreement which it was not bound in law to keep? In other words, Wells could not complain as against the Summit Investment Company that it had not kept its agreement, because the agreement was void as against public policy. The Wenatchee Heights Orchard Company could never complain of that agreement for the same reason. Why, then, should Wells have a claim against the Wenatchee Heights Orchard Company because of that fact?

In conclusion, we can only say that the only case cited by counsel which is on the question of fraudulent conveyances at all is the *American Oak Leather* case in 181 U. S. That case was based, however, as we have pointed out in our other brief, solely upon the proposition that there was no actual intent to defraud. If there had been an actual intent to defraud, then the Court, as it says, would have followed the opinion of the Circuit Court of Appeals for the Seventh Circuit, which is found in 96 Fed. 891. In this case there is fraud, by reason

of the self-expressed intention of Wells, the appellant, to put the property of the corporation where creditors would believe the corporation no longer owned it and, therefore, be discouraged from starting suits against it. What else constitutes actual fraud in a conveyance by an insolvent debtor?

We trust the Court will not understand from what we have said that we concede that the return of this property to the trustee of the Wenatchee Heights Orchard Company was a voluntary conveyance. Every step that has been taken has been looking towards a re-conveyance, has been taken only after litigation commenced and as a means of settlement. The lower Court, in his opinion (Record, page 48) found expressly that it was not a voluntary surrender. We contend that there is in the record more than ample evidence to justify this finding and none that is contrary to it.

One other serious question presents itself in the consideration of this case. Has the illegal transfer to the Summit Investment Company been rescinded so far as the Wenatchee Heights Orchard Company is concerned? It is true that the Summit Investment Company has deeded the property to the trustee. Has that deed, however, any greater effect than would a judgment against the Summit Investment

Company in a suit by the trustee? The conveyance was made solely because of the finding already made by this Court that the conveyance was made to hinder, delay and defraud creditors. If a suit had been brought by the trustee to recover this property and he had recovered judgment and there had been any surplus after paying the creditors of the Wenatchee Heights Orchard Company that surplus would have gone, not to the Wenatchee Heights Orchard Company, but to the Summit Investment Company. No different rule applies where the conveyance is made before judgment and merely for the reason that the conveyance has already been declared invalid. In this case, if there is any surpdus after the paying of the debts of the Wenatchee Heights Orchard Company then the surplus goes to the Summit Investment Company and not to the Wenatchee Heights Orchard Company. That being true, so far as the Wenatchee Heights Orchard Company itself is concerned, the illegal transfer made by its trustees to the Summit Investment Company has never been rescinded. Its equity in the property over and above the amount of its liabilities it has lost forever. For that equity it received the notes originally issued to Wells and McPherson. Why should a court of equity now take from it that con-

sideration which it received for its property, the conveyance of which has caused it to be involved in litigation and adjudged a bankrupt and deprived of the exercise of its corporate rights? What greater price could have been paid for these notes than has been paid by this bankrupt and by its creditors? What more ample payment could have been made?

Respectfully submitted,

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